No. 356



IN THE

# Supreme Court of the United States

OCTOBER TERM—1947

PEDRO SANCHEZ,

*Petitioner,*

—against—

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

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*of Counsel*

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PEDRO SANCHEZ,

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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TO THE HONORABLE FRED M. VINSON,
*Chief Justice of the United States,*
*and the Associate Justices of the*
*Supreme Court of the United States:*

Your Petitioner, PEDRO SANCHEZ, respectfully prays for a Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit, to review a judgment of that Court entered on June 21, 1947, affirming a decision of the Tax Court of the United States, entered on June 27, 1946, which affirmed two deficiencies assessed against the Petitioner-Taxpayer with respect to his Income Tax Return for the calendar year 1940. This petition and the review sought thereby shall be confined to one of said deficiencies, namely, the deficiency of $8,678.30.

## Statement of Matters Involved

Petitioner, a non-resident alien individual, filed his Federal Income Tax Return for the calendar year 1940 with the Collector of Internal Revenue for the Second District of New York. Omitted therefrom was an item of $8,678.30. In omitting this item, the Petitioner took the position that it constituted royalties based upon the use of a patented process in several foreign countries and was, therefore, in come from a source outside the United States and non-taxable to the Petitioner. The Respondent determined that the exclusion of this income was a deficiency in that the source thereof was within the United States (p. 5).

This determination was affirmed by the Tax Court and by the United States Circuit Court of Appeals for the Second Circuit.

## Nature of Controversy

The Petitioner is the inventor of a process used in the chemical treatment of sugar involving the use of a chemical reagent. Both the process and the chemical reagent are covered by world-wide patents (pp. 5, 6, 57). The Petitioner, by a series of agreements, ultimately assigned his rights to his patented process to Sucro-Blanc, Inc., a New York corporation, reserving unto himself the right to receive royalty payments based upon the use of the process by persons, firms or corporations dealing with said Sucro-Blanc, Inc. (pp. 57, 58).

Sucro-Blanc, Inc. sold to its various customers, in a number of foreign countries, the patented product necessary to the use of the patented process, but granted, along with such sales, licenses for the use of the process by such

customers (pp. 8, 9, 10). Pursuant to his agreement with Sucro-Blanc, Inc., the Petitioner was entitled to and did receive 10% of the selling price of the sale by Sucro-Blanc, Inc. of the patented product necessary to the patented process (pp. 8, 54).

All of the sales in question were made to persons in foreign countries; the products so sold were for use in foreign countries and the licenses thereby granted were utilized in foreign countries (pp. 8, 9).

The Respondent has determined that income to the Petitioner, based upon the foregoing facts, during the calendar year 1940, amounting to $8,678.30, constitutes income from sources within the United States, and this determination has been affirmed by the Tax Court and by the United States Circuit Court of Appeals for the Second Circuit.

## Question Presented

The sole question presented is whether the income of $8,678.30 constitutes income from sources outside the United States and therefore non-taxable to the petitioner, a non-resident alien individual.

## Reasons for the Allowance of the Writ

1. The United States Circuit Court of Appeals below has used the wrong criteria in determining the question presented, and has thus promulgated several rules of law which are untenable and contrary to an Act of Congress.

2. The United States Circuit Court of Appeals below has interpreted an important statute, and has thus decided an important question of Federal law which has not been, but should be, settled by this Court.

The foregoing reasons are discussed in the appended brief.

WHEREFORE, your Petitioner prays that a Writ of Certiorari issue to the United States Circuit Court of Appeals for the Second Circuit demanding said Court to certify and send to this Court, on a day to be designated, a full and complete transcript of the record and all proceedings of said Circuit Court of Appeals had in this cause, to the end that this cause may be reviewed and determined by this Court; that the judgment of the Circuit Court of Appeals be reversed; and that the Petitioner may be granted such other and further relief as may seem proper.

Dated: New York, N. Y.,
September 17, 1947.

PEDRO SANCHEZ,
*Petitioner.*

By: MILTON R. WEXLER,
*Counsel for Petitioner.*

HARRY L. GUTTER
ARNOLD H. SHAW
*of Counsel*

IN THE

# Supreme Court of the United States

OCTOBER TERM—1947

PEDRO SANCHEZ,

*Petitioner,*

—against—

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

### Opinions Below

The opinion of the Tax Court of the United States below is reported in 6 T. C. 1141.

The opinion of the Circuit Court of Appeals below is reported in 162 Fed. 2nd 58.

### Jurisdiction

The judgment of the United States Circuit Court of Appeals for the Second Circuit, now sought to be reviewed, was entered on June 21, 1947. The jurisdiction of the Supreme Court of the United States is invoked under Section 240 of the Judicial Code, as amended, also known as Title 28 U. S. Code, Section 347 (a).

## Statute Involved

Section 119 of the Internal Revenue Code (Title 26 U. S. Code, Section 119), so far as same is applicable to the question at bar, provides as follows:

"Section 119. Income from sources within United States.

(a) Gross income from sources in United States. The following items of gross income shall be treated as income from sources within the United States:

* * * * * *

(4) Rentals and Royalties.

"Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties from use or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises and other like property; and

* * * * * *

(c) Gross income from sources without United States.

The following items of gross income shall be treated as income from sources without the United States:

* * * * * *

(4) Rentals and Royalties.

"Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for

the privilege of using without the United States, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises and other like property."

## Statement of the Case

A summary statement of the case is set forth in the Petition. In the interests of brevity, and in compliance with Rule 38 of the Rules of this Court, this statement will not be repeated in this brief, but reference thereto is hereby made.

## Specification of Errors

1. The Circuit Court of Appeals erred in sustaining the deficiency which involves the inclusion of income earned from sources outside the United States based upon the privilege of using a patented process by foreign licensees in foreign countries.

2. The Circuit Court of Appeals erred in determining that the place of the sale of the patented process was determinative of the sources of the Petitioner's income.

3. The Circuit Court of Appeals erred in not holding that the sources of the Petitioner's income were determined by the place where the privilege of using the patented process was exercised.

4. The Circuit Court of Appeals erred in not holding that the sales of the product in question were merely selected by Petitioner and his assignee as a suitable means whereby the amount of royalty income to the Petitioner may be measured.

5. The Circuit Court of Appeals erred in not holding that Sucro Blanc, Inc. was merely the instrumentality through which the Petitioner received royalty payments rather than the source of royalty payments to the Petitioner.

6. The Circuit Court of Appeals erred in not holding that the product in question was sold merely as an incident to the granting of licenses for the use of the patented process in foreign countries.

7. The Circuit Court of Appeals erred in not holding that the place of sale of the patented product is irrelevant and immaterial to the question of source of income where the patent is used in foreign countries.

8. The Circuit Court of Appeals erred in not holding that the place of manufacture of the patented product is of no consequence as to the question of source of income where the patent is used in foreign countries.

## Summary of Argument

The effect of the decision of the Circuit Court of Appeals is to disregard the criterion for determining the source of income derived from the use of a patent, as provided in Section 119, Internal Revenue Code.

## THE ARGUMENT

**The effect of the decision of the Circuit Court of Appeals is to disregard the criterion for determining the source of income derived from the use of a patent as provided in Section 119, Internal Revenue Code.**

We begin with the proposition that the situs of the place where a patent is exercisable is the sole and crucial test in determining the source of payments derived from such use. Section 119(c) (4), Internal Revenue Code, *supra*. It is significant that the foregoing statute is silent as to the manner in which the royalty is to be paid. No mention is made concerning the place where it is paid and the situs of any contract or agreement relative thereto. Nor is mention made of the place where the patented process is manufactured. Only the situs of the place where the patent is actually used is the material factor. (*Commissioner of Internal Revenue* v. *Pedras Negras,* 127 Fed. 2d 260, C. C. A. 5th.)

Notwithstanding the undisputed facts that the patents in question were utilized in a number of foreign countries, the courts below have held that the income derived from such use constituted income from a source within the United States, since certain contracts with respect thereto were executed in the United States and the moneys were actually paid to Petitioner by a domestic corporation.

It follows, that in basing their decisions on such factors as place of sale, place of payment and place of manufacture, the Courts below have disregarded the only criterion expressly provided for in the statute, namely, the place of use of the patent.

It is submitted that where, as in the case at bar, a license governing the use of a patent is granted, in determining the

source of royalty payments thereunder, the place where the licensing contract is made and the place where the product necessary to the process is manufactured are inconsequential factors which cannot be read into the clear, unambiguous and simple language of Section 119(a) (4) of the Internal Revenue Code, *supra*.

Nor can it be held, as the Courts below have held, that the income has a domestic source on the ground that the patented product used in the patented process was manufactured in the United States and the money paid in the United States by an American corporation. (*Commissioner of Internal Revenue* v. *Pedras Negras, supra;* I. T. 2735, XII, C. B. 131.)

The precise question presented warrants settlement by this Court, since it involves the interpretation of an important Federal Statute, and the promulgation of an important rule of Federal law.

## CONCLUSION

**For the reasons stated in the petition and in this brief, it is respectfully submitted that the application for a writ of certiorari should be granted.**

Respectfully submitted,

MILTON R. WEXLER
*Counsel for Petitioner*

HARRY L. GUTTER
ARNOLD H. SHAW
*of Counsel*

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# In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 356

PEDRO SANCHEZ, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT*

## BRIEF FOR THE RESPONDENT IN OPPOSITION

### OPINIONS BELOW

The opinion of the Tax Court (R. 4–17) is reported at 6 T. C. 1141. The opinion of the Circuit Court of Appeals (R. 57–59) is reported at 162 F. 2d 58.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 21, 1947. (R. 60.) The petition for a writ of certiorari was filed on September 19, 1947. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

The taxpayer, a nonresident alien, is the owner of certain domestic and foreign patents to which he granted exclusive world-wide rights to a licensee. He was entitled to a portion of the sales price received by his licensee, a domestic corporation, which manufactured and sold the patented product in the United States. In instances where the product was to be used abroad, the licensee gave the purchasers royalty-fee sublicenses to use the product and the process in foreign countries under taxpayer's foreign patents.

Was the court below correct in concluding that the income received by the taxpayer from his American licensee was, regardless of where the product was ultimately used by the purchasers, income from within the United States and taxable to the taxpayer under Sections 211 (b) and 212 (a) of the Internal Revenue Code?

## STATUTE INVOLVED

Internal Revenue Code:

> SEC. 119. INCOME FROM SOURCES WITHIN UNITED STATES.
>
> (a) *Gross income from sources in United States.*—The following items of gross income shall be treated as income from sources within the United States:
>
> * * * * *
>
> (4) *Rentals and royalties.*—Rentals or royalties from property located in the

United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

* * * * *

(c) *Gross income from sources without United States.*—The following items of gross income shall be treated as income from sources without the United States:

* * * * *

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties; and

* * * * *

(26 U. S. C. 1940 ed., Sec. 119.)

SEC. 211. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

* * * * *

(b) *United States business or office.*—A nonresident alien individual engaged in trade or business in the United States or having an office or place of business therein shall be taxable without regard to the provisions of subsection (a). * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 211.)

SEC. 212. GROSS INCOME.

(a) *General rule.*—In the case of a nonresident alien individual gross income includes only the gross income from sources within the United States.

* * * * *

(26 U. S. C. 1940 ed., Sec. 212.)

**STATEMENT**

The taxpayer, a resident of Havana, Cuba, was a nonresident alien during the taxable year of 1940. He is the inventor of a certain process for treating and clarifying sugar solutions, and of an improved chemical re-agent, called Sucro-Blanc, which is used in that process. The taxpayer secured patents both in the United States and in certain foreign countries covering these inventions. (R. 5–6.)

In 1934, the taxpayer granted the full and exclusive world-wide rights to employ these patents to a licensee. (R. 6.) On July 1, 1936, by virtue of an agreement between all of the parties this license was assigned to Sucro-Blanc, Inc., a New York corporation, from whom the taxpayer became entitled to receive certain payments which, as modified by a subsequent agreement made on September 18, 1937, consisted of 10 percent of the price received by the licensee on all sales of the chemical, Sucro-Blanc, made by it. The taxpayer was also entitled to receive

37½ percent of the proceeds realized by the licensee from any sale, assignment, sublicense, or other disposition of any of the patents or patent rights. (R. 7–8.)

In June 1940, another agreement was entered into by the parties which purported to clarify their previous agreements. It characterized the moneys payable to the taxpayer as constituting royalties and stated that the method of computing such royalties was merely a gauge in determining how much of the consideration was based on royalties for the granting of the exclusive license under the foreign patents and how much for the license under the United States patents. In addition, Sucro-Blanc, Inc., was required by the agreement to keep and maintain records showing the sales made by virtue of the exclusive license granted under foreign patents and those under the exclusive license granted under the United States patents. (R. 8.)

The licensee manufactured the chemical in the United States and all sales by it occurred in this country. Some of the sales were made to customers who utilized the product in the United States. Other sales were made to purchasers who utilized the product in foreign countries; the amount paid to the taxpayer by the licensee with respect to the latter sales was $8,673.30, the item of income in dispute in this case. (R. 8.) In all cases where the chemical was used outside

the United States, the licensee made no charge to the purchasers for the privilege of their utilizing the product or the process in the foreign countries under the foreign patents and, instead, gave them a royalty free sub-license. (R. 9–10.) The Tax Court held that all of the income paid to the taxpayer by his licensee on its sales of the chemical, regardless of where utilized by the purchasers, was income derived from sources within the United States and was taxable in its entirety to the taxpayer. (R. 11–15.) The Circuit Court of Appeals upheld the Tax Court's determination. (R. 57–59.)

**ARGUMENT**

1. The decision below is correct. The taxpayer's petition is formulated entirely on the supposition that the income in question consisted of royalties paid to him for the use of certain foreign patents. (Br. 7–10.) This is a clear misconception of the facts which were found by the Tax Court, on the basis of which both it and the Circuit Court of Appeals determined the case. The taxpayer is an inventor of a process for clarifying sugar solutions and also of a chemical product which is utilized in the process. He owns the domestic and certain foreign patents relating to the process as well as to the product. (R. 5–6.) The taxpayer granted the exclusive, world-wide rights under his patents to a licensee, a domestic corporation, and, during the taxable year, was

entitled to receive from his licensee royalties equal to 10 percent of the price received by it on its sales of the product and also royalties equal to 37½ percent of all sums received by the licensee from any sale, assignment, sublicense or other disposition of the patents made by it. (R. 6–8.) The licensee manufactured the chemical product in the United States and all sales of the product were made by it in this country. (R. 8–10.) While some of the purchasers shipped the chemical to foreign countries for utilization there, they were never required to pay any royalties to the licensee on account of the taxpayer's foreign product and process patents; instead, in all instances those purchasers were granted the right to utilize the foreign patents royalty free. (R. 10.) As a result, the only income received by the taxpayer from his licensee consisted of royalties based on the manufacture and sale of the product within the United States; he never became entitled to receive any payments from the licensee on account of his foreign patents since the licensee never exacted any royalties for their utilization. In these circumstances, the taxpayer is clearly mistaken in asserting that, whenever the chemical was utilized abroad by the purchasers, he received royalties under his foreign patents which would constitute income from sources outside the United States under Section 119 (c) (4) of the Internal Revenue Code, *supra*. Since no charges were

made for the use of the foreign patents, the taxpayer never received any income from them. And, since the only payments which the licensee made to the taxpayer were based on its manufacture and sale of the product in the United States, his royalties arose only under his United States patents,[1] and those royalties, being classified as gross income from within the United States by Section 119 (a) (4) of the Internal Revenue Code, *supra,* are made taxable to a nonresident alien under Sections 211 (b) and 212 (a) of the Internal Revenue Code, *supra.*

2. The taxpayer is likewise mistaken in asserting (Br. 10) that this case raises a question concerning the proper interpretation of the taxing statute. The courts below did not deny that, if the taxpayer had received royalties on account of his foreign patents, such income would have been derived from sources without the United States and would not have been taxable to the taxpayer. The only question in this case was whether the taxpayer was correct in asserting that he did receive such royalties. This having been determined against him, and it is difficult to see how any other conclusion could have been reached

[1] *Extractol Process* v. *Hiram Walker & Sons*, 153 F. 2d 264 (C. C. A. 7th), and *Caterpillar Tractor Co.* v. *International Harvester Co.*, 106 F. 2d 769 (C. C. A. 9th), illustrate the fundamental principle that a manufacture or sale in this country of a patented article involves a necessary use of the United States patent.

on the basis of the undisputed facts, the application of the statutory provisions followed as a matter of course.

3. No conflict in decisions exists and none is asserted by the taxpayer. *Commissioner* v. *Piedras Negras B. Co.*, 127 F. 2d 260 (C. C. A. 5th), relied on by the taxpayer (Br. 9–10), did not involve royalties on domestic or foreign patents, and the decision there has no bearing on the question presented here.

## CONCLUSION

The decision of the Circuit Court of Appeals is correct. There is no conflict in decisions; and no question of statutory interpretation is presented. Accordingly, further review is not warranted.

Respectfully submitted.

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